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**FROM SOCIALISM TO MARKET:**
**CHANGING THE RULES**
**OF THE GAME**

**1992**


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**Working Paper No. 27**


This publication was made possible through support provided by the U.S. Agency for International Development, under Cooperative Agreement No. DHR-0015-A-00-0031-00.



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IRIS SUMMARY

Title: From Socialism to Market: Changing the Rules of the Game

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The transformation of the formerly socialist economies into market economies requires changing the rules of the game for government officials, business people, workers, and other actors. This paper looks at the problems of this transition in light of the new institutional approach to the process of institutional change. One of the lessons of this approach is that institutional change is necessarily incremental, as innovative actors explore new patterns of behavior and evaluate the consequences, while other actors decide whether to emulate the innovators or to stick with familiar behavior patterns. The pace of institutional change thus depends on the experiences of the innovators. These considerations suggest a government strategy of opening avenues for innovators rather than confronting entire segments of the population with demands for radical change.

One of the implications of this approach is that rapid privatization of the large industrial state-owned enterprises (SOEs) has absorbed too much of the attention of top policy-makers and donors, and too little attention has been devoted to setting up the conditions under which new enterprises can emerge and thrive. These conditions involve developing the appropriate framework of laws and regulations under which private firms operate, channeling capital to the nascent private sector, and making appropriate infrastructure investments.

One of the prominent features of the societies in transition is budgetary pressure, as central government revenues have declined and there are urgent needs for government expenditure. An institutional approach to this problem, as described by Kornai, McKinnon, and Murrell, suggests that some of the old mechanisms of control be retained on SOEs that are not ready for privatization or whose privatization will be delayed for one or another reason. Direct controls may be the most effective way of restraining SOE expenditures. The ultimate target is of course decentralized decision-making under a regime of hard budget constraints. But such a regime constitutes a major institutional change, which will probably have to put in place incrementally.

The paper also discusses some specific issues that arise in the transition: (a) convertibility and price liberalization, (b) managing the SOEs, (c) financial sector restructuring, (d) large privatization, (e) direct foreign investment, (f) housing privatization, and (g) taxation policy. The paper suggests that some of the standard policy prescriptions that economists have offered for economies with functioning capitalist institutions need to be re-thought for the not-yet-transformed socialist economies.

# FROM SOCIALISM TO MARKET: CHANGING THE RULES OF THE GAME

Christopher Clague

Conference on Transition to Advanced Market Economies
Warsaw, Poland, June 22-25, 1992

When the countries of Central and Eastern Europe decisively rejected communism and embraced the idea of a market economy and a democratic polity, the initial forecasts of the growth of these economies were quite optimistic. Many observers thought that once the repressive communist bureaucracies were removed, the energies of the populations would be released in a constructive manner and a functioning market economy would emerge quickly. The key to the transition was seen by many to be rapid privatization of the state enterprises that dominated the centrally planned economy.

These expectations have been thoroughly confounded by events. Production started falling dramatically in all the economies in transition, even in those where the Communist parties were swept from power and replaced by governments pronouncing their earnest intentions to move to a market economy as rapidly as possible. Despite the ambitious schemes for mass privatization put forward by governments, the actual privatization of large enterprises has been proceeding slowly. The idea that all the newly freed economies needed was for the government to get out of the way has been shown to be quite wrong.

It is ironic, as noted by Mancur Olson (1992a), that the transition from central planning to the market is characterized by substantial declines in output, while the earlier transitions in the other direction were not accompanied by especially notable retrogressions in the level of production. This observation poses an interesting paradox, because capitalism is thought to thrive on spontaneity and decentralization, while central planning presumably requires careful investigation and forecasts by the central government, which would seem to require some time to get started. An interpretation of the transition ought to provide an explanation for this paradox.

In the years immediately following the dramatic political events of 1989 there has been intense discussion of the problem of the transition and much greater recognition of the difficulties of changing from planning to the market. In these discussions some very different perspectives on the nature of the transition have emerged. Interestingly, among economists with essentially similar views on how a market economy ought to function, there are very different views on how to make the transition from Communist central planning to the market. In other words, while there is general consensus about the location of the desired territory, there is much disagreement on the path to be taken to get there.

There is general agreement on the nature of the difficulty of the transition. Capitalism is an interdependent set of institutions, which do not function very well unless most of them are in place. For example, decentralization of decision-making to enterprises does not lead to efficiency if the enterprises face soft budget constraints, or if prices are regulated by the government at levels far removed from scarcity values. But the institutions of capitalism cannot be created by a series of strokes of the pen, and they cannot all be created at once. Thus the issue inevitably arises whether there is an optimal sequence of changes, and if so, which ones should come first, and how quickly one stage should be followed by the next.

Given the difficulty of the transition, as experience has shown, I think a useful analogy is that of getting a sailing ship out to sea. Many coordinated actions need to be taken just accomplish that task; it is not necessary to win a race, nor to get all the sails rigged, but enough of the parts of the ship need to be working so that the ship moves out of the harbor and avoids the shoals on the way to the sea. I put emphasis on the shoals because there seem to be serious dangers confronting economies in transition if decisions are made badly. Obviously if the economy suffers a prolonged crisis, there is the danger that democracy will not survive. Moreover, apart from that peril, there is a risk of descending into a regulated, rent-seeking, crony capitalism of the kind that has plagued many developing countries and kept them in poverty.

There are a great many tasks that need to be performed by the government if there is to be a successful transition. It will be useful for further discussion to classify these tasks into three categories. First, there is an urgent need for new rules and laws, courts to enforce them, and lawyers and judges who understand them. Law and rules are needed for commercial transactions, contracts of all kinds, labor-management relations, health and environmental protection, accounting standards for purposes of taxation and investor protection, bank regulation, property ownership, landlord and tenant rights, and so on. Second, there are important public management tasks: (a) price restructuring and liberalization, and anti-monopoly policy, (b) macroeconomic balance, including managing the budget and the supply of credit, (c) implementing a new taxation system that will collect taxes from the private sector, and (d) setting up a safety net, with targeted assistance replacing subsidies on commodities and to enterprises. Third, there are tasks related to privatization: (a) small privatization, or the sale of retail shops, trucks and buses, restaurants, repair shops, and the like, (b) large privatization, or the privatization of the large enterprises that dominate the economy, (c) privatization of dwellings and land, and (d) financial reorganization, or the cleaning up of the balance sheets of enterprises and state banks so that both the banks and the enterprises can be privatized. One point to note about this list of tasks is that large privatization is only one of many that need to be performed; in many discussions of the transition, the task of large privatization attracted most of the attention, perhaps partly because it is intellectually the most challenging of the issues for economists. However, it is becoming clear from the experience of the postsocialist economies that their transformation process involves much more than the privatization of the large enterprises that dominate their economies.

In the discussions of the transition by economists, there is a dichotomy between two general approaches.[1] One is found in the writings of Kornai, McKinnon, and Murrell and may be called the evolutionary approach. The other, represented by Lipton and Sachs, Vaclav Klaus, the London Economist, and many others, might be called the rapid privatization approach. This latter approach tends to view the progress of the transition in terms of the pace of privatization of the assets of the economy and argues for rapid privatization along with the other tasks listed above.

These two approaches to the strategy of the transition will be compared in Section 2, while some specific policy issues arising in the transition will be discussed in Section 3. Prior to that discussion, however, it is useful to mention some general issues relating to economic policy in the transition. One question is the extent to which the conventional wisdom of Western economics or Western economic advisers is applicable to the problems arising in the course of the transition. Another way to put the question is to ask whether there is a new field of "transitionology", in which the perspective on policy questions arising in formerly socialist economies attempting the transition to a market economy is fundamentally different from the policy questions arising in other economies, in particular the overregulated but essentially market economies of the non-Communist world. One point of view on this

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[1] My purpose here is to present some ideas, not to review the literature. In any case, I am not familiar with the literature in languages other than English. For some citations to the exploding literature on the transition, see Blanchard et al. (1992), the Fall 1991 issue of the Journal of Economic Perspectives, and the various chapters in Clague and Rausser (1992).

question is that the problems are not fundamentally new and that economists have well thought out and well tested answers to the question of how to get the government out of the way of the private economy so that it can function effectively. Obviously another view is that the problem of the transition from socialism is sufficiently different from that of liberalizing an overregulated market economy that many basic policy questions have to be re-thought.

Another issue arising in policy discussions is whether one adopts a technocratic stance of laying out for the policy maker the best options from the point of view of efficiency and equity, or whether one adopts a political economy view, in which the economic adviser is thinking about and modeling the political forces as well as the economic ones in a given situation. In a sophisticated political economy view, the adviser does not merely rule out the first-best option when it is politically infeasible and go on to the second-best option, but she thinks about how political forces may be affected by economic proposals and programs. Good arguments can be made on both sides of this issue. The political economist can point out that it is surely wrong to assume that an economic proposal will be enacted in its entirety and carried out effectively, and consequently proposals may turn out in practice to have very different effects from those intended. The technocratic economist, on the other hand, can point out that under the color of political economy considerations one can come up with practically any answer to a particular policy problem, and it might be better for economists to be very clear about what makes economic sense so that policy-makers do not have any excuses when they pursue political goals at the expense of sound economic policy.

The present paper will try to keep these various perspectives in appropriate balance. Clearly there are many lessons of conventional economics that were ignored under Communism and that are directly applicable to the formerly socialist economies in transition. Some of these basic lessons continue to be ignored. But the problem of this transition is sufficiently different that some conventional wisdom is probably not applicable. Economic policy reform in this context is not just a matter of laying out the directives from the national government; the societal institutions have to change, and this can only come about as people change their behavior and their expectations about the behavior of others. Thus the attitudes and expectations of the participants are a crucial aspect of the process; citizens of formerly socialist countries are not accustomed to operating in a market economy, and that will affect both their economic and political behavior. These considerations do not necessarily argue for a slow transition, but they do argue for careful thought about how to get from here to there.

## 2. Approaches to the Transition

The case for rapid privatization of the large enterprises can be explained as follows[2]. These enterprises contain the bulk of the assets and the labor force of the economy. The resources are being used inefficiently and will continue to be so used until they are put into the hands of genuine owners. Commercializing these enterprises and forcing them to operate according to market principles is only the first step. In the absence of an effective representative of capital, the enterprises will distribute available resources to the employees, neglecting investment, or if prevented by wage controls from that course, they may undertake investment projects with low social returns. Experience in Yugoslavia and Hungary has shown, it is argued, that "market socialism", in which publicly owned or self-managed enterprises deal with one another through market mechanisms, does not lead to efficient resource allocation. If, on the other hand, an enterprise has private owners, these owners will put pressure on management to cut costs, reorganize, downsize, and do whatever is necessary to make the enterprise profitable. If management efforts fail to accomplish that goal, the enterprise will go under and release its resources through a process of liquidation.

It can be argued that enterprise performance will deteriorate while it remains publicly owned and the central planning agency relaxes its control over the firm's decisions. The managers are then even more free to make personally profitable deals with managers in other enterprises, at the expense of the firm's profits

[2] For elaboration of these arguments see, for example, Hinds (1990), Lipton and Sachs (1991), Borensztein and Kumar (1991), Fischer (1992), and Sachs (1992).

and the public treasury. The state-owned enterprises (SOE's) are also free to indulge their preference for dealing with other state-owned enterprises rather than with the new private sector, and thus the new private firms have a hard time breaking into the market. Deals will also be made with private firms run by insiders, at the cost of the SOE's profits and asset position. These practices can only be stopped, it is argued, when private owners, who have something to lose by them, can replace management.

Given the need for rapid privatization, a chain of argument leads more or less inexorably to mass privatization schemes with vouchers and financial intermediaries, such as those being attempted in Czechoslovakia and Poland.

It should be noted that the proponents of rapid privatization by no means ignore the other tasks of the transition that were sketched above. But they argue that all these changes should be done quickly, so that the market economy can be made operational as soon as possible.

The proponents of the evolutionary approach[3] claim that a society cannot suddenly change from one economic system to another by the "artificial", or "constructivist" creation by the state of private owners. They are skeptical of mass privatization schemes that appear to set up organizations and institutions that exist in Western countries; such organizations and institutions will not, they argue, function in the intended manner. The institutions of

[3] See Kornai (1990, 1991, 1992), McKinnon (1991, 1992a, 1992b), and Murrell (1991, 1992a, 1992b).

capitalism and the business organizations that exist in the West emerged in an evolutionary process; the emergence of market economies from socialism will have to follow some sort of an evolutionary process as well.

Murrell starts from some basic assumptions about the nature of organizations and societies. Uncertainty is pervasive and information is very costly. Organizations consequently develop routines and codes which narrow the range of choices that individuals face and which make their behavior more predictable to others. Organizations that were created and that functioned in the environment of central planning will have routines that are non-functional in the environment of a market economy. Thus one should not expect the SOEs, or any large organization, to exhibit much adaptability in the face of radical changes in the environment.

Under classical central planning there were many external constraints on the way enterprises could use their resources; relaxation of these constraints under reform socialism created the soft budget constraint, as described by Kornai and McKinnon. Under this regime the firm was still engaged in negotiations with the central authorities over how it used its resources. Under capitalism of course, firms are normally quite free in their decisions about how to use their labor and capital resources, but they face a hard budget constraint. Forcing an organization to shift from a regime of tight external controls or a regime of loose controls and a soft budget constraint to one of freedom of action but with a hard budget constraint requires an enormous change in the internal functioning of the enterprise.

There is widespread agreement among commentators on the transition that macroeconomic balance is essential. It is hard to see how a market economy can begin to function in an environment of rampant inflation. Thus control over the budget is absolutely critical, and one of the legacies of reform socialism is a budget deficit brought about by the decline in the flow of profits taxation from the enterprises to the treasury (McKinnon, 1992). Where the evolutionary school differs from the rapid privatizers is not in the importance of achieving budgetary control but in the means for doing so. The rapid privatization school focuses on the end state of the market economy, and says, "Let there be hard budget constraints". The evolutionary school doubts that such pronouncements will be effective and suggests retaining some of the old methods of control over SOEs during an interim period. In particular, SOEs would not be permitted to undertake investment projects or raise employee remuneration without authorization from the central government.

Let us think about the process of change from the point of view of the government leadership. There are a number of key actors whose behavior will determine the outcome. Among these key actors are the managers of SOEs, the newly appointed Boards of Directors of enterprises, lower-level officials in the national ministries, local government officials, and actual and potential entrepreneurs. How can the government leadership set in motion forces that will lead to convergence toward market economy institutions?

It should be recognized that there is enormous uncertainty about the future course of events. The world is normally full of uncertainty, and that is one reason why most people do not normally contemplate radical changes in their daily lives. They continue to follow past patterns of behavior with marginal adjustments as long as that is a feasible option. It is hardly surprising that many national and local officials are continuing in past patterns, with moderate adjustments to the new situation. There are working relationships between supplier and user enterprises, between enterprise managers and bank officials, and between local government officials and enterprise officials. Some of these relationships facilitate productive activities, while others are undoubtedly privately profitable but socially unproductive.

The evolutionary point of view is that the best strategy for change is to proceed incrementally. Since a great deal of past patterns of behavior will necessarily continue for some time, the top leadership should attempt to contain the most harmful aspects of this behavior, while opening avenues for new types of activity. Clearly there is much variation in the willingness to innovate, in the population at large and among the key decision makers in the public and private sectors that were mentioned above. By opening avenues for innovators in the public and private sectors to explore, the leadership can enable change to occur and can arrange for successful innovators to be rewarded. Successful innovators will be emulated; given the pervasive uncertainty of the world, people rationally are strongly influenced by examples of those they consider to be their peers. Thus a small number of successful innovators can lead to waves of followers.

The key decision makers will be watching the evolution of events, and will be deciding whether and in what direction to change their patterns of behavior. They will be more impressed by their observations of actual behavior of others than by government pronouncements. In particular, dramatic government pronouncements that are not followed by corresponding changes in behavior will weaken the effects of future pronouncements. On the other hand, a government that proceeds with credible, incremental changes can bring about substantial cumulative changes over time. Observers will be responding to the second derivative as well as the first. Therefore an evolutionary approach does not necessarily imply a lengthy transition, only one that proceeds incrementally.

What do these considerations suggest about the case for rapid privatization? Several arguments can be advanced to support the proposition that the key to a successful transition does not lie in the rapid privatization of the large state enterprises. First, the physical assets were constructed under the old system and they are simply not worth much with the new set of world prices and new quality standards associated with Western markets. Being cut off from Western technology and sheltered from international competition, large sectors of the economy are using obsolete equipment and production processes (Pohl, 1991). Some of the factories have been estimated to generate negative value added;

that is, they use inputs whose value at world prices are worth more than they output they generate. Second, the assets come with labor force attached, if enterprises are privatized. Imagine a Western company contemplating taking over an existing organization and trying to modernize it, or adopting the green field approach, and building a new factory next to the old one, and hiring selectively. It seems plausible that the green field approach would frequenty be preferable, in light of the characteristics of organizations described above. Thus even if the physical assets would be worth something, as organizations they are not worth much. Third, even if as organizations they are valuable, dividing them up is going to be a divisive process that will inevitably take time. Moreover, if the process is done rapidly, it will be messy, and some people will make fortunes while others will be left with neither jobs nor assets. This outcome could create a backlash against the market system.

If large scale privatization will not be rapid or will not work well, then what is best strategy for a successful transition? Under the right conditions, the new private sector, or the new companies that emerge, may provide the main driving force of the economy. For such companies to emerge and prosper in a socially productive way, the other tasks listed above must be accomplished. These require budgetary control, new taxation sytems, cutbacks in government subsidies, while the safety net targets assistance to those in need. Letting the prices be set in markets seems to be essential, or the prices will not reflect scarcity values and the wrong incentives will be given. And the new rules must be made clear. These rules of secure private property and enforceable contracts are absolutely necessary for getting new companies started and for attracting foreign companies (Olson, 1992b).

This section has presented some of the ideas of an evolutionary approach to the transition, although Kornai, McKinnon, and Murrell would not necessarily agree with all the points that have been expressed. The next section will discuss some particular issues that arise during the transition.

With regard to an issue that was raised at the end of the introduction, it is clear that I think that a good deal of the conventional wisdom of Western advisers needs to be re-thought before being applied to the peculiar problems of the transition. Implicit in the evolutionary approach is the notion that history matters a great deal, and therefore "transitionology" is an important new field of theoretical inquiry and empirical observation. Those watching from the front lines are in an excellent position to contribute.

## 3. Specific Issues in the Transition

The different approaches to the transition have implications for many of the specific issues that arise. A few of these issues are discussed here, namely (a) convertibility and price liberalization, (b) managing the state-owned enterprises, (c) financial sector restructuring, (d) large privatization, (e) direct foreign investment, (f) housing privatization, and (g) taxation policy.

a. Convertibility and price liberalization. Prior to the Big Bang in Poland, there was considerable doubt in the minds of some observers about the wisdom of attempting to establish current account convertibility at an early stage in the transition (see for example the essays by Levchik and Nuti in Williamson, 1991). The concern of these observers was first that convertibility of foreign exchange was not desirable if domestic prices were still controlled at arbitrary levels. But price liberalization was thought to be politically unacceptable because of the drastic effects on the cost of basic commodities and economically undesirable because of the perverse incentives of SOEs and their monopoly power.

But the case for liberalization of prices at one stroke seems to be very strong on economic grounds. It is hard to see how one can devise sensible incentives for producers and investors if prices are far out of line with scarcity values. Whether one favors rapid privatization of large enterprises or making life possible for the new private sector, the case for market-clearing prices is quite compelling. Moreover, the price increases (accompanied by partial wage corrections) have been surprisingly acceptable to populations in Eastern Europe; at least they have not led to riots and strikes on a massive scale. There does seem to be some grounds for concern that SOEs that are not under an effective hard budget constraint might purchase excessive amounts of foreign exchange on wasteful projects. It may make sense to allow unrestricted foreign exchange purchases by SOEs for current inputs but to require central government permission to buy foreign exchange for investment goods. Such a distinction is consistent with the idea of current account convertibility.

b. Managing the SOEs. If privatization is not going to be rapid, governments are going to be involved in managing SOEs for some time. To make life safe for the new private sector, it is necessary to prevent the SOEs from absorbing too much of the scarce resources, especially investment capital, land and building space, and foreign exchange. In the evolutionary approach, the idea would be to squeeze the state sector, but not so tightly that it ceases to function. A crucial issue in managing the SOEs is what to do with the enterprises that are losing money under the newly liberalized prices. This issue is closely related to the problem of financial restructuring, since typically the large enterprises have large debts to banks and to other enterprises; see part c below. One should not expect dramatic improvement in the efficiency of operation of these enterprises, and continuing subsidies may even be preferable to massive layoffs in conditions of already substantial unemployment. An unemployment rate of 12% would seem to be sufficient to supply labor to the new private sector. Nevertheless, some closures of large factories are probably desirable. Another issue is whether the moribund enterprises should be supported by explicit budget subsidies, as recommended in standard World Bank advice, or protected from imports by tariffs. The case for tariffs is in general a shaky one because of the danger of entrenchment of vested interests, but in the conditions of the transition, an argument in favor of them is the urgent and perhaps temporary need for government revenue that is likely to prevail.

Another issue in managing the SOEs concerns restructuring. Should demonopolization precede privatization, or should the whole enterprise be privatized and the new owners decide what parts to keep together and what to spin off? In a functioning market economy, the latter course is appealing, as the decisions about dividing up the enterprise would not be made by government officials. But in the context of an emerging market economy there are several arguments for demonopolizing the SOEs at an early stage. First, they may remain SOEs for a while, and they will have better incentives if they are broken up and lose their monopoly power. Second, they are easier to privatize if they are smaller. Third, experience in the West indicates that it is hard to break up existing monopolies. And fourth, the government could be accused of bad faith if it sold an enterprise and then proceeded with antitrust action against it (Newbery 1991).

c. Financial sector restructuring.

One of the obstacles to rapid privatization of large enterprises is the confused nature of the balance sheets of these enterprises and the banks which have lent to them. The enterprises have accumulated debts and assets against other firms as well as with the banks. The standard advice is to clean up the balance sheets in some way or other, and recapitalize the banks with new government funds. This advice is usually accompanied by the observation that incentives cannot be right without clear property rights. But we observe that governments are extremely slow at cleaning up these balance sheets; this result is not surprising in view of the highly contentious nature of the issue. An evolutionary approach would suggest that the state enterprise sector should be constrained by the overall budget and by direct restrictions on firms in situations where inter-enterprise credit is ballooning out of control. Meanwhile, delays in resolving these ambiguities in debts and assets of old organizations should not be allowed to stand in the way of organizing an efficient check-clearing mechanism and of providing finance for new enterprises. There is a strong case for the government to provide finance for new entrepreneurs, even those without collateralizable assets. Foreign banks can play a valuable role in this task, and as Kornai observes, one of the most useful contributions that could be made by foreign governments and international organizations is providing credit to the private sector entrepreneurs (Kornai, 1991). There is a serious danger that in an austere stabilization program the irresponsible SOEs will absorb virtually all of the available credit and unduly constrain the growth of the new private sector (Murrell, 1992a).

d. Large privatization.

There would seem to be many ways in which mass privatization schemes could fail. The enterprises could end up under control of management with little effective supervision by the owners; this outcome could arise because individual shareholders simply hold on to their shares, making it expensive to mount a takeover bid, and because mutual funds fail to exert control over management. Some shareholders may get bought out at low prices or by fraudulent dealings, leading to popular outcry against the injustice. The mutual funds buying up individual vouchers may not be able to fulfill their promises of redemption at ten times the purchase price. The possibility of collapse and scandal seems very real. These considerations do not provide a compelling case against voucher-type privatizations, but they do argue for proceeding incrementally and attempting to learn by experience[4].

e. Direct foreign investment

Poland urgently needs to incorporate Western technology into its productive activities. Individual experts could be hired by Polish organizations, and licenses for technological processes could be negotiated with foreign companies, but there are serious incentive problems in these arrangements. It is difficult to

[4] The Czechoslovak government is carrying out its plan with a good deal more consistency than the Polish government. Czechoslovakia has been a comparatively rule-obedient society, even under Communism, and it may be able to implement mass privatization much more successfully than other postsocialist societies. On the current state of the Czechoslovak and Polish plans, see the articles by Brada and Slay in RFE/RL (1992).

devise an efficient compensation scheme for the individual experts since the process of technology transfer is a complicated one involving the coordinated actions of many individuals. Similarly, once a license for a technology has been purchased, the license seller does not have a strong incentive to provide all the accompanying information that is needed to make the technology transfer successful. Technological information does not reside merely in blueprints and equipment but also in the heads of people who have been working with the technology, and especially in <u>teams</u> of such people. (The fact that successful transfer requires a <u>team</u> provides a disincentive for an individual expert to risk her money or her reputation as an executive on a venture into the highly uncertain environment of a formerly socialist economy. On the other hand, an executive with a proven track record in her base of operations does not risk a career-damaging outcome from becoming the head of such an operation (Laban and Wolf, 1992).) Market economies provide strong competitive pressures for the development of organizations that can manage technology effectively; we have seen that centrally planned economies, although they produced well-trained scientists and technicians, have not generated the conditions under which such organizations emerge. Multinational corporations (MNCs) in the West are well positioned to set up operations in new countries, by transferring capital, equipment, and teams of managerial and technical experts. Their incentive to do so is of course the profits they can make. Under the right conditions, the profits realized by MNCs are likely to be a small fraction of the social gains in productivity resulting from the MNC activity.

Why are the social gains likely to exceed the MNC profits by a large margin? First, if there is competition among MNCs, their profits will be driven toward the cost of their operations; clearly competition among MNCs is far from perfect, but the forces of competition are not absent and could be exploited by host countries. Second, successful operation of an MNC facility conveys information to local entrepreneurs, who may be able to compete with the MNCs in particular activities. Third, the MNC will offer training opportunities to local citizens, not only in technological areas but also in management skills. Fourth, to the extent that the MNC is more profitable than the activities it replaces, the tax revenues of the government will be higher.

One can easily imagine circumstances in which MNC activity does not contribute to the development of the host country. Much depends on the policies followed by the host country government, and whether the MNC is able to manipulate these policies to its own advantage. It is easy to construct examples in which special privileges granted to these companies turn their activities into a net cost rather than a benefit for the host country.

There are two considerations that call for caution in laying out the welcome mat for direct foreign investment (DFI) in Poland. The first is that the regime offered to foreign investors should be seen by Polish citizens as fair (Moskwa (1991) discusses Polish attitudes toward DFI). This consideration may or may not provide a constraint on the regime that a technical economic adviser would recommend to policy-makers. More on this point below. The second reason for caution in opening the doors to foreign investment is that in the period before privatization has proceeded very far, the prices of assets in Poland are likely to be low in relation to their future streams of earnings, because the domestic population has very little accumulated savings.

There does not seem to be any way to induce an optimal amount of DFI. All avenues have some limitations. One approach is to privatize the firms to domestic residents first and then let the foreign companies buy up enough shares to gain control. If domestic shareholders realize that a foreign company is likely to gain control, and that this takeover will increase the value of the shares, these shareholders will hold out for a price that reflects the expected future value of the enterprise. This approach makes a good deal of sense, and it does represent the eventual regime for foreign investment, but until privatization takes place, it suffers from the limitations of mass privatization schemes. Moreover, a law requiring a foreign company to announce its intention to buy up the shares in a particular firm would be subject to strong temptation to subvert the rule. Domestic fronts could be used to buy up some of the shares before it was generally realized that a foreign company was interested in buying the enterprise.

Another approach is for the government to negotiate with the foreign company on behalf of the domestic citizens. In this case there is of course the danger of private (bureaucratic) interests selling out the national interest. In addition, as Froot (1992) points out, in a bargaining situation between the MNC and the government, the government would not be expected to hold out for as high a price for the shares as would an individual investor who expected a successful foreign takeover, because the individual investor has the option of not selling his shares and waiting for the company to make its purchases from other shareholders, an option that is not open to the government in a bilateral bargaining game.

Some of the forces holding back foreign investment are the same as those holding back domestic private entrepreneurs: deficiencies in the laws relating to real and intellectual property, contracts, labor and environmental regulations, and inability to contract for transportation, storage and housing services. One approach would be to try to remedy these legal deficiencies in the near term and to be very clear on the equal treatment of domestic and foreign business. The idea would be to explain to the Polish people that this equal treatment implies that Poland is not being exploited. The trouble with this approach is that there needs to be some detailed negotiations between the government and MNCs about particular enterprises, so the equal treatment message will not be convincing. It would have to be combined with the message that competition among MNCs would keep them from reaping excessive profits.

### f. Housing privatization

In contrast to the enormous attention directed toward privatization of the large state enterprises, comparatively little attention has been devoted in the academic literature to the privatization of dwellings. This contrast is all the more curious once one recognizes that the value of the housing stock is probably considerably greater than that of the large SOEs in manufacturing (Hinds and Pohl, 1991) and that in principle the privatization of housing should be simpler to carry out than that of the manufacturing enterprises. The general rule guiding privatization is that separable property should be the first to be privatized, because that is administratively easiest. That is why small privatization is recommended as the first step, and has in fact been implemented to a large degree in Poland. Apartments in large buildings are not as separable as retail shops or trucks, but they are surely more separable than the assets of large factories. An advantage of privatization of dwelling units is that it would contribute to the development of the financing of new enterprises, since it would provide assets that would serve as collateral for loans.

Lack of expertise and space preclude a detailed treatment of the housing sector in Poland, but a few observations and general principles will be suggested here[5]. About a fifth of the dwelling units are in communal housing that was provided by the national government at rents far below the cost of even maintenance and

[5] Sources on this topic include Merrill et al. (1991), Struyk et al. (1991), and Gray et al. (1991).

repair, not to mention the capital costs. Ownership of these buildings has been transferred to the local governments, or gminas. Another quarter of the units are in cooperative housing, which also receives subsidy from the state, although less than that accorded to communal housing. People in these units are accustomed to paying low rents and tenants have typically remained in their units for many years. Under the old system, occupants were led to hold the expectation that they would not be dislodged from their units. In striking contrast to the West, the buildings contain households of very different income levels and consequently different abilities to pay higher rents.

What are the options for privatizing the communal housing? With regard to ownership of the buildings, there would seem to be three options: continued gmina ownership, collective ownership by the occupants (or a subset of them), and private ownership by a third party. Under all three options there is need for an increase in rents, and it would seem sensible to implement a substantial increase while the buildings remain the property of the gminas. These local government units are in need of revenue, not only for the maintenance and repair of the buildings but for other purposes as well. Moreover, rent increases are likely to be much more socially acceptable if they are for the benefit of the community than if they were to go to a third party private owner of the building. In fact, it is easy to imagine that a private investor would not want to pay much for a building in which the tenants were accustomed to paying extremely low rents and the new owner's rights to increase rents and to evict tenants had not been tested. A program of housing allowances tied to income would seem to be essential to prevent hardship resulting from the rent increases.

Once rents are increased to realistic levels, and once laws covering landlord and tenant rights are passed and implemented, the rights to individual units could be separated from the responsibility for the building as a whole; that is, the rent could be divided conceptually into two parts, the rent for the individual unit and the fee for the upkeep and capital cost of the building. Under continued gmina ownership of the building, individuals could be given the right to purchase their units and thereby be relieved of the obligation to pay the rent for the unit, although they would still be responsible for their contribution to the building upkeep. Individuals could acquire ownership of multiple units and could sublet them. The gminas could also contemplate turning over the buildings to either private owners who would manage them or to collective ownership by a subset of the tenants (or perhaps all of them). The gminas' need for revenue would motivate them to sell the buildings rather than give them away.

In summary, the key to progress in housing privatization would seem to be the raising of rents to realistic levels and the implementation of property rights and landlord-tenant legislation. In principle the process should not have to be long delayed. It is interesting that in Lithuania the privatization of dwelling units is proceeding rather smoothly while the privatization of large enterprises is still being organized (Girnius, 1992). On the other hand, in eastern Germany, where large-scale privatization is being carried out with extraordinary speed, the housing sector is the one area where market principles are being applied only very slowly (Pohl, 1991).

g. Taxation Policy

It seems clear that conditions of budgetary stringency will be the normal pattern in postsocialist economies. Some measures to relieve budgetary stringency are the same as in market economies, and the conventional wisdom of Western experts would seem to be quite applicable. The replacement of commodity subsidies by targeted assistance programs, the imposition of user fees for education, health, and infrastructure services, and the implementation of new systems of taxation are examples of these. In carrying out such measures, for example the implementation of a value-added tax system, it would seem that the experience and expertise of the international organizations would be of considerable value. Careful planning of the sequence of steps, and education of the businesses and the public about their obligations and rights, seem, on the basis of experience in other countries, to be essential (Tanzi, 1992; Tait, 1992).

If it is correct to assume conditions of <u>extreme</u> budgetary stringency, then some interim measures that would not normally be countenanced by market-oriented economists may be warranted. A fairly high (uniform) import tariff may be indicated, as such a tax is probably implementable in the near term. Direct restraints on SOE spending and extraction of SOE profits by direct measures is another possibility. These are situations in which the lessons from market economies may have to qualified and modified to adapt to the reality of the postsocialist transition. In addition of course the attractiveness of giveaways in mass privatization schemes is lessened by conditions of extreme budgetary stringency, and this consideration also tends to support a more evolutionary approach to the transition.

## 4. Concluding Remarks: Changing the Rules of the Game

Ironically, mass privatization schemes may appeal to the same type of mentality that in earlier decades was attracted to economic planning. Both activities run the risk of exaggerating the amount of useful information that can be absorbed and acted upon by a central authority. Both activities lend themselves to sophisticated technocratic schemes which assume rule obedience on the part of bureaucrats and citizens. The world in which we live is not only permeated by uncertainty and high information costs; it is also populated by many organized special interests that are powerless to prevent the announcement of sweeping reforms but are well positioned to fight them in the trenches. I think that both theory and experience indicate that economic reforms are most likely to succeed when avenues are opened for innovation while the entrenched interests are contained but not frontally assaulted. Information cost considerations join with political economy arguments in favoring such an approach.

A successful market economy needs secure property rights and effective means of contract enforcement. Without secure property rights, investors will lack incentives to improve physical property, research patentable techniques, and market new products. Without enforceable contracts, creditors will not make long-term loans, and businesses will forgo profitable exchanges. In short, the economy will not support the elaborate <u>specialization</u> of economic activity that generates technical and organizational progress.

The critical question is, how can individual rights to property and contract enforcement be implemented in a society where in the recent past they barely existed? To say that rights to private property and to contract enforcement exist in a society is to say that individuals have <u>expectations</u> about how others will respond to various actions. When an apartment owner raises the rent and threatens to evict a tenant who doesn't pay, the owner has a secure property right only if he expects his actions to be backed up by the courts and not to be resisted by the other tenants. An equilibrium of expectations has to come into existence. While it is easy to expound on the virtues of an equilibrium of secure rights to property and to contract enforcement, describing the sequence of events that leads to it is a major challenge.

The process would seem to involve many elements, including of course the passage of appropriate legislation, the drawing up of implementing rules by the government bureaucracy, and broader processes of education of the population on the nature of rights that exist in modern market economies. A critical role will be played by those who understand how a market economy is supposed to work and who are participating in or watching the unfolding events from the front lines. There is a great deal yet to be learned about what is going right and what is going wrong in the economies in transition, and detailed study of the processes will be extremely useful.

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